ARE STOCK DIVIDENDS INCOME?

Apparently the decision of the United States Supreme Court that stock dividends are not income and hence not subject to tax under the Sixteenth Amendment was generally expected. A flood of such dividends followed the decision and led to protests in some quarters that large profits accumulated during the war period were now being distributed untaxed. Hence proposals have been made, even by those who considered the principle of the decision correct, to levy a tax on stock dividends similar to the stock-transfer tax, and Senator Nelson of Minnesota has proposed a constitutional amendment subjecting them to the income tax.

It is difficult to understand the court's having reached the decision it did. It may well be that questions will arise in individual instances as to the values on which taxes should be levied or the rates to be applied in taxing stock dividends, but it hardly seems possible that the principle itself can be finally established that stock dividends do not ever represent income. A decision to that effect carries with it the enunciation of a legal principle that may have far-reaching effects and will result in the practical impairment of the surtax provisions of the income-tax law as a source of revenue to the federal government.

Justice Pitney, writing the majority opinion, said that the person receiving a stock dividend "has received nothing that answers the definition of income in the meaning of the Sixteenth Amendment." The amendment however, merely permits taxation of incomes without apportionment. It does not define income. The decision thus rests on the issue whether or not the distribution of stock to the stockholders, rather than of cash, is to them a realization of income.

That fact, apparently, has not been determined by the court's opinion. What was settled, merely for the time being, is the law of the land. As little will it be determined if Senator Nelson succeeds in putting through his constitutional amendment. Indeed,

the attempt to determine an economic fact by either legislative or judicial dicta does seem just a bit amusing. If the decision is correct in its analysis and stock dividends are not income, efforts to tax them as such are ridiculous. If the decision is not correct it should be possible to levy an income tax on stock dividends without recourse to constitutional amendment.

The court held that a stock dividend is capital, is

> in essence not a dividend but rather the opposite; no part of the assets of the company is separated from the common fund, nothing is distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution. . . . . . Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital and no longer is available for actual distribution. The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit. . . . .

It is of course well known that surplus profits distributed as stock dividends are often far from being so "absorbed in the business as to render it impracticable to separate them for withdrawal," as, for example, when they are in the form of government or railroad bonds or the stock of other companies. The more important fact is that the government has failed to differentiate between stock dividends based upon increased valuations placed upon good-will in a reappraisal of the assets as a result of the increased earning power of the corporation without additional investment, and those based upon the additional investment of accumulated profits for the purpose of extending its operations. In the former case there is some excuse for exemption unless and until the increased value is actually realized by sale. The situation in this instance is similar to that of the increased market value of any piece of property, which increase, however, is not taxable until evidenced by the actual sale of such property.

When, on the other hand, the stock dividend is based upon the accumulation of profits which, instead of being distributed to the individual stockholders, are invested in the business of the corporation itself or in any other manner, we have an entirely different

situation. In such instances it is not true that the transfer from surplus account to capital account tends to postpone the realization of profits; no more so would be the case if the cash, borrowed possibly, were actually distributed and immediately reinvested by the distributees in the increased capital stock of the corporation concerned. Here is the real essence of the usual stock dividend. It is income reinvested in the stock of the corporation making the distribution. The fact that when a stock dividend is declared the money "remains subject to business risks which may result in wiping out the entire investment" is just as true of income from any source whatever that is invested instead of being consumed for personal expenses. Suppose that, instead of declaring a stock dividend, the corporation were first to secure subscriptions from its stockholders for the additional stock or sell them bonds secured by the additional capital assets represented by the surplus and then were to use the money realized from the sale of either stock or bonds to distribute a cash dividend on the old stock from surplus. What difference would there be between this sort of a transaction and the declaration of a stock dividend that warrants the exemption of the latter procedure, but not of the former?

The court insisted that stock dividends represent the growth of capital. The growth of capital, however, is possible only by the addition of income, just as, to use the figure referred to by Justice Pitney, the growth of additional trees is possible only by the planting of the fruit as seed instead of consuming it.

The court's analysis of stock dividends as capital, the insistence that "an accumulation of profits by the company" do not represent income for the stockholders because it is impracticable "to separate them for . . . . distribution" and because "the stockholder has received nothing out of the company's assets for his separate use" can rest only upon the view that corporation and stockholders are distinct entities. As Professor Fairchild says in upholding the decision, "This analysis rests upon the fact that the corporation is an entity separate from the shareholders, and nothing but confusion can come from failure to recognize the independent entity of the corporation . . . . and it is gratifying to find in Justice Pitney's opinion this clear statement of the matter

from the legal side."[1] And indeed, despite the objection of Justice Brandeis that "the law finds no difficulty in disregarding the corporate fiction wherever that is deemed necessary to attain a just result," Justice Pitney found it his duty "to look through the form," and he could not

> disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company, which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact, but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder.

Before discussing the validity of this argument it may be well to consider some of its practical results. Section 216*a* of the 1918 Income Tax Law, like similar provisions of previous acts, allows a credit deduction to the extent of the normal tax on the incomes of individuals derived from dividends received from corporations taxable upon their net earnings. Section 234*a*, paragraph 6, similarly exempts from taxation all dividends received by corporations from others taxable upon their net earnings. The theory of this allowance, as explained by Montgomery, the accounting expert, is that the corporation income tax merely represents a mode of collection at the source, and that the failure to grant such deductions would result in double taxation of the same income. Obviously, however, this theory and hence these provisions in the present law are justifiable only if there is no difference between the corporation and its stockholders, if the income of the corporation is *ipso facto* the income of the stockholders. In view, therefore, of the language of a supreme court opinion on this very point, it becomes immediately incumbent upon the Congress to repeal the above-cited sections in the present income-tax law. The present corporation income tax is not an income tax at all, but merely a franchise tax on the privilege of doing business under the corporate

[1] Fred R. Fairchild, "The Stock Dividend Decision," *Bulletin of the National Tax Association*, April, 1920, p. 208.

structure rather than the partnership. That is the logic of the situation, a logic that if followed by action will undoubtedly result in wiping out the holding company, at least.

The more immediate fact is, as Justice Brandeis argued, that the corporation is merely an extension of the partnership. The stockholders, and not the directors, make up the corporation. The directors merely act as the agents of the stockholders, just as the elected officials of a municipal corporation are the agents of the citizen electorate. The city is the citizens thereof, not the elected officials. It is true that the individual stockholder as such has little control over the assets and the distribution thereof. He cannot withdraw his share as easily as can any member of a partnership, but that is merely because he has promised to play the rules of the game, in return for which he has certain privileges which protect him and give him advantages not possessed by a partner.

There is no question, so far as the corporation itself is concerned, that the accrued surplus earnings above expenses are its net income, subject to taxation regardless of the form in which they exist. The surplus may be in the form of salable merchandise, loans to others, or accounts receivable that, contrary to all expectations, may ultimately decrease in value or prove uncollectible. Nevertheless, unless there is a definite excuse for writing them down, the surplus profits are subject to taxation as income. As the corporation is the stockholders who own it and these stockholders make up that corporation, the net income of the corporation is likewise the net income of the stockholders from this particular source. By virtue of their ownership of the stock they have a vested right in the assets of the corporation and any accretions to those assets. At the option of the majority holdings acting through the directors, or by direct vote of the stockholders if the action of the directors is unsatisfactory, the stockholders can determine the disposition of the accrued net increase in assets. If cash is available or can be secured in exchange for or on the strength of the existing assets, the distribution of a cash dividend for at least a considerable portion of the surplus is the normal procedure. If, because of market conditions, additional working capital is needed for a short period of time, the dividend may be paid in scrip. Should there

appear to be a reasonable assurance of increased profits as a result of enlarged operations, the stockholders may themselves decide or be induced by the directors to permit the retention of their distributive shares of the profits for investment in more extensive operations. This is done by the transfer from surplus to capital account of the amount otherwise intended for distribution as dividends. The evidence of such a transaction appears in the form of a stock dividend.

At what point this surplus should be subjected to the levy of an income tax, whether before or after distribution to the individual stockholders, is a question of policy and administration to be determined by the taxing authorities. To facilitate collection it was deemed desirable to collect the normal tax at the source and join it to the corporation tax. In view of the policy decided upon by Congress of levying a progressively larger surtax upon such individual incomes as furnish indication of ability to bear a heavier burden of taxation, it is probably easier to levy the tax after distribution rather than before. As it may involve practical difficulties, at least in the case of the larger corporations with very numerous stockholders, to hold the individual stockholders accountable for their respective shares of the undistributed surplus, Congress has constantly made efforts to devise means of forcing distribution.

Individual accountability is nevertheless required of the stockholders of personal service corporations. Section 218*e* of the Income Tax Lax of 1918 provides that

> amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and *any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.*[1]

To accept such a legal provision without objection is indicative of a belief that the surplus of the corporation represents the accrued income of the stockholders, whether distributed to them or not.

As stockholders of personal service corporations are taxed in the same manner as are members of partnerships, the latter present

[1]The italics are ours.

an analogous situation. Section 218*a*, regarding the taxation of the members of partnerships, rules as follows: "There shall be included in computing the net income of each partner his distributive share, *whether distributed or not*,[1] of the net income of the partnership for the taxable year."

Thus the Income Tax Law clearly proceeds on the principle that surplus is income, whether it is distributed or not. This conception of the nature of surplus is still more readily visible in the method prescribed for the computation of net taxable incomes of individuals derived from business or professions. The net income is that sum which is left after deducting from the gross income or revenues all expenses and losses incident to the conduct of the business or profession. There is disregarded entirely any question as to the amounts drawn in cash for personal needs or the amounts permitted to remain in cash or otherwise for the extension of business operations. That portion of the profits added to capital account and left "subject to business risks which may result in wiping out the entire investment" is taxable, with only such deductions for credit as are allowed on profits actually withdrawn for personal use. Will the individual, on the basis of the principle developed in the case of *Macomber* v. *Eisner*, be able to secure exemption from tax on the amount left invested in the business as capital? Or will he be compelled, in order to secure the benefit of the decision, to incorporate his business, distribute in the form of a cash dividend to himself so much of his profits as he requires for his personal use and increase his capital stock to the extent of the balance of the surplus profits for distribution to himself as a stock dividend?

It must be evident from these quotations from the law as it stands that it was consistent in its definition of income when it declared stock dividends taxable, except, possibly, in so far as it failed to make provision for such individual instances that might be exempted because they do not represent accumulations of past surpluses. The majority opinion in this case has resulted in a new definition for the income of corporations other than personal service corporations. Will that difference be permitted to remain,

[1] The italics are ours.

or will individual business and professional men, the members of partnerships and the stockholders of personal service corporations, insist upon a definition for their own incomes consistent with the definition enunciated in this decision of the court? If stock dividends are to be exempted because the assets represented by these dividends have become capital—and the Sixteenth Amendment did not contemplate or permit a tax on capital without apportionment—it will be indeed surprising if these individuals do not make strenuous efforts to secure similar exemptions for the distributive shares of undistributed surplus profits on similar grounds, that they remain capital assets "subject to business risks which may result in wiping out the entire investment."

In addition to opening the way for further exemptions, the decision will result in greater frequency of stock-dividend distributions. Some such distributions have already been made, ranging up to four times the original capital of the corporations concerned. Aside from the probable incentive to stock watering, the declaration of a stock dividend will become the most logical and the simplest method to pursue for corporations desiring to enlarge their capital for more extensive operations. It will be the equivalent to inducing their stockholders to subscribe for the new stock at par, in lieu of insisting upon cash dividends, by the promise of an escape from income taxation upon the amounts involved. If cash should be needed, it ought not to prove too difficult to sell the stock. It is true that Justice Pitney said that "if he does sell, and in so doing realizes a profit, such profit, like any other, is income, and, so far as it may have arisen since the Sixteenth Amendment, is taxable by Congress without apportionment." The point has already been raised that such a transaction is merely the exchange of capital. This question may be sidetracked entirely by the sale of the original shares and the retention of the new. In that event, only the profit realized above the price paid on the original shares would be subject to tax. If, on the other hand, a slight loss were suffered, there would be established thereby an excuse for a deduction, in addition to the avoidance of the tax. Inasmuch as the majority of the individuals involved are probably

subject to surtax, there would still remain substantial advantages from sale of the original shares at a loss.

It also seems likely that the decision will lead to a greater concentration of capital. Mergers can form the most frequent excuse for the increase of capital stock to be distributed as stock dividends. How can the law prevent such mergers from being carried out under agreements whereby the stockholders receiving the dividend can give their original shares to the stockholders of the acquired corporation and retain only the new stock with a consequent distribution of untaxed surplus? The method may be slightly complicated, but it will surely be worth the trouble to save the amount of the tax. The steps are somewhat as follows:

Corporation A with $1,000,000 cash surplus in its treasury wishes to distribute that surplus to its stockholders without subjecting it to the income tax. It is decided to acquire corporation B, with assets and capitalization of $1,000,000, for the par value of its capital stock. The stockholders of the latter corporation are willing to accept stock in the former in exchange for their own. The purchase is made. Corporation A acquires the capital stock of corporation B, paying therefor into the hands of trustees $1,000,000 in cash. It then declares a stock dividend to its stockholders for a like amount. The stockholders turn in an equal amount of their original stock to the above-mentioned trustees in exchange for the cash. The trustees give this stock to the former shareholders of corporation B, who have in this roundabout manner exchanged their stock for that of corporation A. Meanwhile the stockholders of corporation A have secured a cash dividend without being subjected to an income tax thereon. If they hold the new stock long enough to pass it on to their heirs, the dividend will have escaped such taxation forever.

The possibility of evading the payment of income taxes by means of such transactions indicates even more clearly that stock dividends based, not upon revaluations of capital assets, but based upon past accumulations of surplus profits, are realized income to the stockholders receiving such dividends and should be taxed as such. There is nothing to be gained by favoring a small

class and granting them exemptions because of a misunderstanding. Some means must be found to reopen the case once more in order that the Supreme Court may reverse itself. The opportunity will come if a test case be based upon the application of the principle laid down by the court to the three other classes of income mentioned in the aboved iscussion. In the meantime it may very well be that the insistence upon such reversal of the decision would come from those who now uphold it if Congress acts upon the suggestion made and repeals sections 216*a* and 234*a*, paragraph 6.

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